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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Commissioner, Internal Revenue Service

ORIGINAL

IRS Needs To Curb Excessive Deductions For Self-Employment Retirement Plans

19

Excessive Keogh deductions are costing the Federal Government millions of dollars annually in lost revenue. IRS can reduce the frequency and amount of excessive deductions by providing Keogh plan participants more guidance in tax instructions and by developing service center checks and followup mechanisms to detect and correct errors.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-208060

The Honorable Roscoe L. Egger, Jr.
Commissioner of Internal Revenue
Department of the Treasury

Dear Mr. Egger:

As you know, self-employed individuals have been allowed, since 1962, to deduct certain amounts they contribute to retirement plans authorized by the Congress. Such plans, referred to as "Keogh" or "H.R. 10" plans, accounted for an average of $2 billion in annual tax deductions during tax years 1977 through 1980.

Because the legal requirements associated with Keogh plans are complex, there is considerable potential for error in computing allowable deductions. Through its Taxpayer Compliance Measurement Program, the Internal Revenue Service (IRS) estimated that excessive Keogh deductions totaled $34 million for tax year 1976. We recently completed our analysis for tax year 1977 which indicated that excessive Keogh deductions may have totaled $114 million that year.

The differences between IRS' sample results and our results can be attributed to several factors. IRS analyzed returns filed for tax year 1976 whereas we analyzed returns filed for tax year 1977. Also, IRS used a stratified random sample approach while we employed a pure random sampling technique. Further, our estimate for 1977 could be somewhat overstated because, in analyzing our sample tax returns, we had to assume that taxpayers were participating in a specific kind of retirement plan. Nonetheless, both samples confirmed that excessive Keogh deductions represent a problem which needs to be addressed. Because the Economic Recovery Tax Act of 1981 authorized higher Keogh deductions for tax years after 1981, IRS should take steps now to reduce excessive deductions and the tax loss which accompanies them.

Although tax law simplification would be the best means for dealing with the problem of excessive Keogh deductions, simplification will be a long-term project. Meanwhile, IRS can reduce the frequency and amount of such deductions by (1) revising Form 1040, its accompanying instructions, and Publications 17 and 334 and (2) developing and implementing service center mathematical checks and followup mechanisms aimed at correcting errors.

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In commenting on a draft of this report by letter dated July 27, 1982, you generally agreed with our findings and conclusions. You also outlined a series of steps that IRS will take to implement our recommendations. Your comments are discussed further on page 13 and included in full in the appendix.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our audit work were to evaluate IRS' administration of the Keogh provisions and to determine whether any potential or actual compliance problems were associated with the provisions. Our review was conducted in Washington, D.C., and consisted primarily of analyzing a randomly selected sample of returns filed in 1977 which contained Keogh deductions. We also interviewed IRS officials and analyzed the Internal Revenue Code provisions and IRS publications dealing with Keogh plans. Our review was performed in accordance with generally accepted Government auditing standards.

COMPLEX RULES GOVERN KEOGH DEDUCTIONS

Through the Self-Employed Individuals Retirement Act of 1962, the Congress sought to encourage self-employed persons to make early financial plans for their retirement years. The act authorized a tax deduction from gross income for contributions to retirement plans meeting certain specific requirements. Tax qualified benefit plans for self-employed individuals are referred to as Keogh plans in recognition of a persistent advocate of such plans, former Representative Eugene Keogh of New York.

To qualify for tax deductions, contributions normally must be made to a self-employment retirement plan lodged with a bank or other financial institution which acts as trustee or custodian. Contributions may be invested in annuities, endowment or life insurance, investment grade stocks, or U.S. Government bonds. Keogh retirement plan funds may be distributed to a covered individual beginning at age 59-1/2, if the individual has retired. In any case, however, to avoid penalties, distributions must begin before an individual has reached age 70-1/2, regardless of whether the individual has retired.

Two categories of self-employed persons are eligible to set up a Keogh plan--"owner-employees" and certain members of a partnership. An owner-employee is a (1) sole proprietor or (2) partner with more than a 10 percent financial interest in the capital and/or profits of a partnership. Sole proprietors or partners who set up tax-qualified Keogh retirement plans must assure that the plans provide for the retirement needs of all employees who have

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3 or more years of service with the business. 1/ Similarly, provision must be made for each partner who has less than a 10 percent capital or profits interest in the partnership. When a partnership includes no owner-employees or includes one or more owner-employees who elect not to set up a Keogh plan, the remaining partners may set up independent Keogh plans. Such partners, who have less than a 10-percent interest, need not make provision for employees or other partners in their Keogh plans.

Self-employed persons eligible to set up Keogh plans must choose between two types of plans--defined contribution and defined benefit plans. And, as discussed below, the plans' characteristics and rules regarding tax deductions differ markedly.

Defined contribution plans

Under a defined contribution plan, a self-employed individual may set aside certain funds each year in an individual account maintained by a bank or other financial institution. However, to be eligible, an individual must have net earnings from self-employment. Also, annual contributions are limited by law to certain percentages of net earnings and/or certain dollar amounts. The value of the account, from a retirement standpoint, depends on the amounts contributed and the extent to which investments prove successful.

Funds deposited in defined contribution plans may be deducted on an individual's tax return only if the individual had net earnings from self-employment activities for the year covered by the tax return. The maximum annual deduction allowed a self-employed person for contributions made to such an account is 15 percent of earned income from self-employment or $7,500 2/, whichever is less. However, the deduction allowed a person with a self-employment income of less than $5,000 and an adjusted gross income equal to or less than $15,000 is limited to 100 percent of earned income from self-employment or $750, whichever is less.

Defined benefit plans

Under a defined benefit plan, an individual sets aside sufficient funds each year to ensure that, upon retirement, a fixed

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1/Contributions made by employers on behalf of employees qualify as a normal business expense and may be deducted on the appropriate tax return.

2/Increased to $15,000 by the Economic Recovery Tax Act of 1981. The previous limitation of $7,500 is referred to throughout this report because it was in effect for the period covered by our review.

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and predetermined pension income will be forthcoming. Thus, a defined benefit plan has a specific expected retirement value. In contrast, as discussed above, the retirement value of a defined contribution plan depends entirely on the amounts invested and the extent to which investments prove successful.

The law governing defined benefit plans thus places limits on the retirement amounts to be realized rather than the annual amounts an individual can contribute to the plan. The maximum allowable deduction for contributions made to the account of the self-employed person is an amount sufficient to ensure, according to accepted actuarial assumptions, the defined retirement benefits which may be accrued under the statute. For example, a 40-year old self-employed individual with earnings of $50,000 1/ could contribute, in any given year, an amount sufficient to generate a $2,200 annual pension beginning at age 65. In this case, the law limits the pension amount to 4.4 percent of the individual's earnings, or $2,200. It does not, however, specifically limit the amount that may be invested to ensure accrual of that pension amount. Rather, the contribution amount would vary with the investment vehicle selected by the self-employed individual.

EXCESSIVE KEOGH DEDUCTIONS REDUCE TAX REVENUES

As discussed previously, the law governing Keogh deductions is complex. That complexity tends to promote the frequency of errors on tax returns which in turn generally reduces tax revenues. For returns filed for 1976, IRS estimates that taxpayers claimed $34 million in excessive Keogh deductions. For returns filed for 1977, we estimate that taxpayers may have claimed as much as $114 million in excessive Keogh deductions. Thus, although the two estimates vary, they both underscore the fact that excessive Keogh deductions constitute a serious problem.

Excessive Keogh deductions for tax year 1976

IRS tested the accuracy of Keogh deductions taken on tax year 1976 returns through its Taxpayer Compliance Measurement Program. That program is used to periodically estimate voluntary compliance levels among individual taxpayers as well as some corporations that file returns.

For tax year 1976, IRS selected and examined a stratified random sample of 50,087 individual tax returns. Included in the

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1/Earnings in excess of $50,000 may not be taken into account in determining maximum annual contribution amounts to a defined benefit plan.

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50,087 returns were 2,774 returns on which Keogh deductions were claimed. Examinations resulted in Keogh deduction changes to 190, or 7 percent, of the 2,774 returns. By projecting those results, IRS was able to estimate, for the overall universe of tax year 1976 returns filed, the number of returns on which Keogh deductions were taken and the total amount of excessive deductions, as shown in the following table. IRS did not, however, seek to measure the impact of these deductions on tax revenues.

Projection category for tax year 1976 returns filed	Projected number of returns in category (note a)	Projected dollar amount of changes in categories (note a)	Coefficient of variation (note b)
			(percent)
Number of returns in universe containing a Keogh deduction	619,994	(c)	± 6.0
If all returns containing Keogh deductions were examined:			
Keogh deduction would decrease	44,167	$33,874,539	± 17.5
Keogh deduction would increase	17,876	$ 4,448,595	± 25.0

a/These estimates are at the 90 percent confidence level.

b/At the 90 percent confidence level, for example, this means that the actual number of returns containing a Keogh deduction ranged from 558,801 to 681,187 (619,994 ± 1.645 standard deviations x 6 percent).

c/Not applicable

The above statistics indicate that, for tax year 1976, 44,167 taxpayers claimed almost $34 million in excessive Keogh deductions, or an average of $770 per return. Another 17,876 taxpayers failed to claim over $4 million in Keogh deductions they were entitled to, or an average of $250 per return. And, as discussed below, we found that such deductions continued to pose a problem in tax year 1977.

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Excessive Keogh deductions
for tax year 1977

To determine whether excessive Keogh deductions represent a continuing problem which merits special IRS attention, we analyzed Keogh deductions taken on returns filed for tax year 1977. Although our analytical method differed from IRS' method, we found that the excessive Keogh deduction problem extended beyond tax year 1976.

For our review, IRS selected a random sample of 50,026 unaudited individual income tax returns from the universe of 86.5 million returns filed for tax year 1977. In selecting the sample, IRS used a random interval selection technique which we prescribed. Of the 50,026 selected returns, 366 contained Keogh deductions. IRS was able to locate and provide to us 334 of the 366 returns.

To analyze the deductions on these returns, we had to make a key assumption concerning the type of Keogh plan involved. In this regard, taxpayers who claim Keogh deductions need not specify on their tax returns whether they contribute to defined contribution or defined benefit plans. Thus, we could not specifically determine, for our 334 sample returns, whether the deductions pertained to defined contribution or defined benefit plans. However, because financial institutions were required to report certain information to IRS in 1977, we were able to develop and use an assumption in analyzing our sample tax returns.

Specifically, we assumed that 95 percent of the returns in our sample contained deductions related to defined contribution plans and that the remaining 5 percent contained deductions related to defined benefit plans. This assumption was derived directly from data supplied to IRS by financial institutions. In 1977, each financial institution managing a Keogh plan with fewer than 100 participants was required to file a report with IRS. Of the 650,000 Keogh plans reported to IRS in 1977, 616,000, or 95 percent, were defined contribution plans. The remaining 34,000, or 5 percent, were defined benefit plans.

We considered the feasibility of matching our 334 sample returns against the reports filed by financial institutions to determine whether the deductions related to defined contribution or defined benefit plans. However, due to insufficient data on plan reports, we were unable to do so. We therefore decided to test the 334 sample returns against the rules governing defined contribution plans, recognizing that the incidence of noncompliance would have to exceed 5 percent in order to be meaningful.

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In analyzing the 334 sample returns, we sought to determine whether each taxpayer was self-employed, whether there were net earnings from self-employment, and whether deductions taken exceeded percentage or dollar limits set forth in the law. As shown in the following table, we found that 50, or 16 percent, of the 334 returns contained unallowable or excessive deductions as measured against defined contribution plan requirements.

	Returns not meeting requirements		
Defined contribution plan requirement	Number	Amount of excessive deductions	Tax loss (note a)
Taxpayer must be self-employed	15	$26,701	$ 8,523
Taxpayer must have net earnings from self-employment	11	18,045	b/4,626
Deduction taken cannot exceed certain percentage or dollar limits	24	21,591	6,849
Total	50	$66,337	$19,998

a/We computed the tax loss by excluding the excessive Keogh deduction from each tax return and recalculating the tax liability.

b/Although these taxpayers had no net earnings from self-employment, Keogh deductions were sometimes used to offset income from other sources. For example, a taxpayer who had a net loss from self-employment of $5,000 could also have earned $25,000 as an employee. The taxpayer thus may have erroneously used a Keogh contribution to offset net taxable income.

As shown above, 15 of the 50 taxpayers who appeared to have taken excessive Keogh deductions apparently were not self-employed. None of the 15 returns contained entries on supporting schedules for professional, business, or farm income or expenses. Further, the 15 individuals listed occupations such as waitress, highway patrolman, fireman, and salesman. Moreover, their reported incomes were basically supported by Forms W-2, which usually are associated with employees rather than self-employed persons.

Another 11 taxpayers reported net losses from self-employment. Six of the 11 taxpayers reported business losses, 3 reported partnership losses, and 2 reported farm losses. If these taxpayers

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were participating in defined contribution plans, their deductions for tax year 1977 were not allowable. In order for their deductions to be allowable, the individuals needed to show a net profit, rather than a loss, from self-employment.

The remaining 24 taxpayers claimed deductions which exceeded legally prescribed percentage or dollar limits. Twenty-two of the 24 taxpayers exceeded the 15 percent/$7,500 limit on contributions. The other two taxpayers exceeded the 100 percent/$750 limit placed on deductions allowed taxpayers with self-employment income equal to or less than $15,000.

We projected the results of our analysis of the 50 cases over the universe of returns filed with respect to tax year 1977. The projections are shown in the following table.

	Returns not meeting requirements		
Defined contribution plan requirement	Projected number (note a)	Projected amount of excessive deduction (note a)	Projected tax loss (note a)
Taxpayer must be self-employed	25,937	$ 46,168,722	$14,737,127
Taxpayer must have net earnings from self-employment	19,020	31,201,625	b/7,988,820
Deduction taken cannot exceed certain percentage or dollar limits	41,498	37,333,017	11,842,612
Total	86,455	$114,703,364	$34,578,559

a/Our estimates are at the 95 percent confidence level. The coefficients of variation are ± 14 percent for the projected number of returns, ± 26 percent for projected excessive deductions, and ± 25 percent for the projected tax loss.

b/See note b on previous page.

The above projections indicate that, for tax year 1977 returns filed, taxpayers may have claimed as much as $114 million in excessive Keogh deductions. In contrast, IRS found, for tax year 1976, that taxpayers claimed about $34 million in excessive Keogh deductions. There are, however, several reasons why our results differed from IRS' results.

First, one would expect differences in sample results on a year-to-year basis, although that clearly does not fully explain the significant differences in our respective sample results.

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Second, however, different sampling techniques were used. IRS used a stratified random sample approach while we employed a pure random sampling technique. Third, and most importantly, our projections probably are overstated because some of the taxpayers in our sample may have been contributing to defined benefit plans; however, we had no way of determining this. But, as indicated earlier, we did anticipate that 95 percent of the tax returns in our sample would contain deductions relating to defined contribution plans; only 5 percent were expected to pertain to defined benefit plans. Nevertheless, to the extent that our sample consisted of returns containing deductions related to defined benefit plans, our projections may be overstated.

In any case, like IRS, we found that a problem exists with respect to excessive Keogh deductions. And, the problem appears serious enough to warrant action on IRS' part.

ACTIONS NEEDED TO CURB EXCESSIVE KEOGH DEDUCTIONS

Because excessive Keogh deductions significantly reduce tax revenues annually, IRS needs to take action to resolve the problem. Action in the near future is particularly important because the Economic Recovery Tax Act of 1981 raised the limits on amounts individuals can deduct for Keogh contributions. Simplification of the law governing Keogh deductions is one means for dealing with the problem. That approach, however, will take some time. Meanwhile, IRS can resolve much of the problem by (1) providing taxpayers with better guidance on the allowability of and limitations on Keogh deductions and (2) developing and implementing a service center program for dealing with excessive deductions.

Providing taxpayers better guidance on Keogh deductions

As previously discussed, the rules governing Keogh plans and their associated deductions are very complex. The key source of information available to taxpayers concerning these rules is IRS Publication 560. Neither the Form 1040 instructions nor IRS Publication 17, a key document used as a guide by many taxpayers, contains any explanation of Keogh plan requirements. Instead, both documents refer taxpayers to Publication 560. Publication 334, the "Tax Guide for Small Business," does contain a brief description of Keogh plan rules. However, that publication does not specify that different rules govern defined contribution and defined benefit plans. And, like the Form 1040 instructions and Publication 17, it also refers taxpayers to Publication 560.

Publication 560 contains a very detailed discussion of Keogh plans and the deductibility of contributions. However, the publication is very complex and contains many technical terms. Moreover, the publication's complexity is compounded by the fact that

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it deals with both defined contribution and defined benefit plans. Yet, as previously mentioned, most taxpayers contributing to Keogh plans are concerned only with the rules related to defined contribution plans.

Because most taxpayers needing information on Keogh deductions are involved in defined contribution plans, IRS could probably limit the problem of excessive Keogh deductions by revising its Form 1040 instructions and Publications 17 and 334. Specifically, IRS could point out that there are two types of Keogh plans and that, to qualify for either, an individual must be self-employed. Further, IRS could point out the additional requirements governing deductions under defined contribution Keogh plans--the individual must have net earnings from self-employment and cannot deduct more than a certain percentage and/or dollar amount of net self-employment earnings. IRS also might want to consider developing a worksheet for taxpayers' use in computing the allowable deduction. The worksheet could be inserted in Publications 17, 334, and/or 560.

With better, more readily available guidance from IRS, taxpayers probably would make fewer errors in computing Keogh deductions. Further, taxpayers who may be neglecting to take Keogh deductions to which they are entitled--a problem which IRS identified through its 1976 Taxpayer Compliance Measurement Program--also might benefit from better IRS guidance. In this regard, providing taxpayers with better guidance on allowable deductions is perhaps the only way to deal effectively with that problem. IRS has no way of knowing whether any given taxpayer is entitled to but has not claimed an allowable deduction. It can only try to alert taxpayers to the fact that certain transactions qualify for tax deductions. On the other hand, IRS can take additional steps to deal with the problem of excessive Keogh deductions. In this regard, even if taxpayers were afforded better guidance, the complexity of the rules governing Keogh plans can be expected to continue generating some errors in the form of excessive deductions. IRS could detect and correct many of these errors through its service center computer operations.

Developing and implementing a service center error correction program

As previously discussed, taxpayers currently are not required to specify on their tax returns whether they contribute to defined contribution or defined benefit plans. Thus, IRS cannot now determine, except via examination, whether deductions taken were excessive. If taxpayers were required to specify on their returns what type of plan they contribute to, IRS could set up a mathematical verification process in its service centers to detect certain excessive Keogh deductions.

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Line 25 of the Form 1040 for tax year 1981 contains space for recording Keogh deductions. The line reads as follows:

"Payments to a Keogh (H.R. 10) retirement plan"

To obtain data on the type of plan taxpayers contribute to, line 25 could, for example, read as follows:

"Keogh payments (enter code from page 4__)"

The required code entry would pertain to defined contribution and defined benefit plans. Afforded that key piece of information, IRS could construct a mathematical verification process for checking deductions taken with respect to defined contribution plans. Specifically, IRS would be able to check, via computer, whether a taxpayer reported self-employment income, whether there were net earnings from self-employment, and whether specified percentage or dollar limits had been exceeded. If mathematical checks disclosed discrepancies, IRS could handle them in the same basic manner it handles its numerous other mathematical verification processes--via computer generated taxpayer inquiries.

Requiring taxpayers to code Keogh payments on the Form 1040 would not be an unusual procedure. IRS currently requires that individuals who deduct payments to individual retirement accounts code their returns to show the type of account involved. This coding permits IRS to check the deductions taken against the limits which apply to individual retirement accounts. With such a coding system for Keogh payments, most excess deductions taken with respect to defined contribution plans could be detected by computer.

CONCLUSIONS

The results of IRS' 1976 Taxpayer Compliance Measurement Program and our work show that many taxpayers claiming Keogh deductions do not fully understand the rules applicable to such deductions. As a result, significant amounts of tax are going uncollected. For tax year 1976, IRS estimated that excessive Keogh deductions totaled $34 million.

Our estimate of the amount of excessive Keogh deductions for tax year 1977 was about $114 million. That is, however, a qualified estimate because of an assumption we had to make concerning the representation of defined contribution plans in the sample of cases we reviewed. Nevertheless, the results of our review indicate that the problem identified by IRS' 1976 Taxpayer Compliance Measurement Program continued in 1977.

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In any case, the problem is significant enough to warrant IRS taking some particular actions to improve taxpayer compliance with Keogh reporting requirements. Because self-employed persons predominantly participate in defined contribution plans, IRS could resolve much of the problem by (1) providing taxpayers with some basic information about such plans in the Form 1040 instructions and Publications 17 and 334 and (2) developing and implementing a service center error correction program. In so doing, IRS would help curb excessive Keogh deductions. As an added benefit, the basic information supplied in the Form 1040 instructions and the publications might prevent some taxpayers from overlooking Keogh deductions to which they are entitled.

We recognize that there are costs associated with revising tax forms and publications and developing and implementing service center error correction programs. We also recognize that there may be other ways to deal with the problem of excessive Keogh deductions. For example, Treasury, IRS, and the Congress could consider ways to simplify the law governing Keogh deductions. In the short term, however, it is clear that limited IRS expenditures directed at resolving the problem could prove very cost beneficial.

RECOMMENDATIONS

To help alleviate the problem of excessive Keogh deductions, we recommend that the Commissioner of Internal Revenue:

--Provide taxpayers with some basic guidance on Keogh deductions in the Form 1040 instructions and Publications 17 and 334. At a minimum, the guidance should specify that taxpayers must be self-employed to be eligible for such deductions. It should also specify that different rules govern defined benefit and defined contribution plans. Further, the guidance should specify, with respect to defined contribution plans, that an individual must have net profits from self-employment to be eligible for a deduction and that the deduction cannot exceed certain percentage and dollar limits. Also, the Commissioner may want to consider developing a worksheet for use by taxpayers in computing Keogh deductions. The worksneet could be included in Publications 17, 334, and/or 560.

--Develop and implement a service center error correction program for excessive Keogh deductions. In so doing, the Commissioner may wish to revise the Form 1040 to require taxpayers to specify whether they contribute to defined contribution or defined benefit plans.

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AGENCY COMMENTS AND
OUR EVALUATION

By letter dated July 27, 1982, the Commissioner of Internal Revenue expressed agreement with our findings and conclusions. The Commissioner further stated that, in response to our recommendations, IRS plans to:

--Revise the Form 1040 instructions and Publication 334 to provide taxpayers with better information on the rules governing Keogh deductions.

--Rewrite Publication 560 with a view toward trying to simplify the complex discussions contained in that document. In so doing, IRS also plans to develop and insert in the publication a worksheet designed to make it easier for taxpayers to compute allowable Keogh deductions.

--Revise Publication 17 to include some basic information about Keogh plan eligibility requirements.

--Investigate the feasibility, from both a legal and an administrative standpoint, of developing and implementing a service center error correction program for excessive Keogh deductions. This effort will include an analysis of the need for revisions to the Form 1040. The Commissioner also plans to evaluate alternative approaches to curbing excessive Keogh deductions. On the basis of that analysis, the Commissioner plans to select and take the most appropriate action to resolve the problem.

The actions proposed by the Commissioner are fully responsive to our recommendations. When implemented, the Service will have taken important steps toward resolving the problem of excessive Keogh deductions.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

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We appreciate the cooperation and assistance provided us by IRS personnel. We look forward to working with you on other tax administration matters in the future.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

JUL 27 1982

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft report entitled "IRS Needs to Take Steps to Curb Excessive Deductions for Self-Employment Retirement Plans."

The Internal Revenue Service is aware that there has been a problem with respect to excessive Keogh plan deductions taken by taxpayers on their Form 1040 returns. Moreover, a current review of our returns processing activity indicates a continuation of this problem.

We agree, generally, with the report's conclusions and recommendations for revising IRS forms and publications to provide better guidance on Keogh deductions. We also agree with the report's conclusion that the IRS needs to be more effective in identifying and correcting returns with excessive Keogh deductions. However, we have not yet determined the best approach for accomplishing this objective. We are currently studying various approaches including the service center approach recommended in the report. Until the study is completed, we would like to reserve final comment on the approach recommended in the report.

Attached are detailed comments on the conclusions and recommendations contained in the report.

With kind regards,

Sincerely,

Roscoe L. Egger, Jr.

Attachment

Department of the Treasury Internal Revenue Service

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Attachment

Detailed Comments

Guidance to Taxpayers

1. As suggested by the draft report, we plan to add a paragraph to the instructions for Form 1040 indicating that filers must have self-employment income and briefly explaining the difference between the two types of plans. If space is available, we will also specify that deductible contributions to a defined-contribution plan are limited to a certain percentage of self-employment earnings and certain dollar amounts.

2. We plan to begin rewriting Publication 560, Tax Information on Self-Employed Retirement Plans, within the next few months. We hope to further simplify the publication, gearing it more to the unsophisticated reader. We will emphasize the following draft report recommendations:

   a. That there are two types of self-employed retirement plans (Keogh plans), defined-contributions plans and defined-benefit plans, and that different tax rules apply to each;

   b. That an individual must be self-employed to qualify for either type of plan;

   c. That, to make deductible contributions to a defined-contribution plan, an individual must have net earnings from self-employment, not a net loss; and

   d. That deductible contributions to a defined-contribution plan are limited to a certain percentage of self-employment earnings and to a certain dollar amount.

   In addition, we plan to add the recommended worksheet. (The worksheet will help a self-employed individual or owner-employee compute his or her proper Keogh contribution and deduction.)

3. In accord with the general recommendations in the draft report, in Publication 334, Tax Guide for Small Business, we will emphasize the draft report recommendations covered in (2)(a) through (d), above.

   At this time, we feel that it would be inappropriate to include a worksheet in Publication 334 for determining the proper Keogh contribution and deduction. The publication is a general guide to the federal tax rules that apply to small businesses. Therefore, we feel that its discussion of Keogh plans should be limited to an overview of the area with a reference to Publication 560.

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4. Although Publication 535, Business Expenses and Operating Losses is not mentioned in the draft report, the publication includes the same discussion of Keogh plans that appears in Publication 334. The same improvements to be made in Publication 334 will be made in Publication 535.

5. Publication 17, Your Federal Income Tax, is generally written for individuals with salaries, wages, or unearned income; it is not aimed at self-employed individuals. Therefore, the publication does not cover self-employment income or deductions in detail. We feel that it would be inappropriate to deviate from this general approach by covering the details of the tax rules for Keogh plans. However, we will add language to the heading of Chapter 12 ("Retirement Plans, Pensions, and Annuities") in Publication 17 to the effect that a taxpayer must be self-employed to be eligible for a Keogh deduction. We will continue to refer readers to Publication 560 for more information on these plans.

Service Center Error Correction Program

1. The draft report suggests that the IRS handle identified Keogh discrepancies in the same basic manner it handles other mathematical verification processes. The scope of the Service's "math error" corrections process is limited by statute. This limitation precludes us from making all corrections that we identify while processing returns as if they were "math errors." There are, however, alternative methods that the IRS may employ to disallow or recover excessive Keogh deductions. We agree that regardless of the method, the problem needs further resolution.

   In order to determine which method provides both a legally defendable assessment and the most economical result, we are asking our legal counsel to review the nature of excessive or unallowable pension plan deductions. We will seek clarification of our assessment authority as well as the types of changes to the Form 1040 or attached schedules that the IRS may institute under the existing statutes.

2. To facilitate computer detection and correction of excessive Keogh deductions, the draft report suggests that we might revise Form 1040 to obtain information from taxpayers regarding which of two types of retirement plans they contribute. While we recognize the potential benefits of having this information, we believe that we must first determine to what extent the IRS can utilize it and whether or not it can be obtained via some other means, before we increase the amount of information requested from taxpayers on the form. This last point is especially important in view of OMB's concern for the practical utility of information collected from the public as well as the Service's commitment to paperwork reduction.

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